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SUBJECT: CODEL HAGEL: CHINESE THOUGHTS ON WORLD FINANCIAL
CRISIS

Reftel: 1) 08 Beijing 03857 2) Paulson-Wang Qishan telcon
Oct 11, 2008

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¶1. (SBU) Summary: On October 13-14, Senator Charles Hagel met Chinese Vice Premier Wang Qishan, Central Bank Governor Zhou Xiaochuan, and Commerce Vice Minister Ma Xiuhong. The Vice Premier discussed weaknesses in the U.S. system that had led to the financial crisis, and asserted China's commitment to cooperate with the United States to resolve the situation, including continuing to buy U.S. debt. Regarding a U.S.-raised G-20 summit idea, Wang noted that the meeting had failed to materialize despite an agreement to attend on China's part, but saw the Chinese quick response to the offer as a positive sign. Wang expressed hope that the incoming Administration would move quickly to clarify their China policies, noting that bilateral meetings such as the Strategic Economic Dialogue (SED) had increased confidence. Although China and the United States would disagree on some issues, and arms sales to Taiwan were regrettable, Wang anticipated continuing the constructive relationship. Governor Zhou and Vice Minister Ma likewise both noted opportunities for cooperation to stabilize financial markets, including a Chinese focus on growing their economy. They saw opportunities for China to continue to reform its economy. End summary.

ang Qishan: Cause of Crisis

¶2. (SBU) Vice Premier Wang Qishan outlined what were in his view the major contributing factors in the U.S. financial crisis: 1) a lifestyle of low savings and high consumption; 2) excessively loose monetary policy and liquidity creation in response to the bursting of the Internet stock bubble and September 11; 3) excessive financial innovation combined with insufficient regulation and supervision, with financial assets priced on complex models that even bank CEOs did not understand; and 4) weak internal risk management, including excessive leverage of financial firms and executive compensation arrangements that paid large

bonuses for strategies that led to large losses.

13. (SBU) Wang said the proliferation of poorly understood financial derivatives had greatly increased financial leverage in the system. The volume of credit default swaps is 62 trillion dollars, far outstripping any basis in the real economy. The bursting of the housing bubble had led to a rapid shift from excess liquidity to a liquidity crisis, threatening a collapse of the entire global credit system and affecting the real economy.

Commitment to Cooperate

14. (SBU) Wang said the Chinese government is very "sober-minded" in facing the crisis. Although the problems started in the United States, the crisis affects the whole world and China is greatly impacted by what happens on Wall Street. Wang estimated that Chinese holdings of U.S. Treasury securities, U.S. agency debt, and corporate stocks totaled USD 1.2 -1.3 trillion.

15. (SBU) Wang supported the USG policy responses to date and is committed to continue cooperation. He noted that the People's Bank of China (PBOC) issued a strong statement of support at the financial markets' most difficult moments, adding that last week China appeared more confident about the prospects for passage of a financial rescue passage than most Americans. China will also contribute to the global economy by keeping its own growth strong, which is why the Chinese monetary policy was loosened last week. He said that China would implement a range of policies to keep

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domestic demand growth steady, as he expects 2009 will be a "most difficult" year for demand in China's major trading partners and thus for China's economy.

16. (SBU) Wang stressed that China is cooperating in deeds, not just words. China has not sold its holdings of U.S. agency debt. In response to USG requests, Wang said China recently bought new U.S. agency bonds. (Note: According to officials of the State Administration of Foreign Exchange, they have maintained their overall holdings of U.S. agency bonds, although they have switch their Fannie Mae and Freddie Mac holdings from long-term to short-term bonds. End Note.) In his view, Senator Hagel said the U.S.-China bilateral relationship is as important as any in dealing with the financial crisis. He said China can rest assured that the Congress will support the Federal Reserve, the Treasury, and the next President to stabilize the financial system, noting the United States will not fail to rise to the challenge of ensuring a prosperous economy. He noted that the United States will inject fresh capital into financial institutions and stand behind the obligations of Fannie Mae and Freddie Mac.

Summit Response

17. (SBU) Wang noted that China's quick positive response to the U.S request that President Hu attend a leaders' summit on October 18 was "unprecedented" and demonstrated China's preparedness to be a responsible member of the global community (see ref telcon.) The request was received on October 10 and by October 12 China had confirmed that President Hu would attend. The MFA and the Embassy in Washington had already made considerable preparations, including booking hotel reservations. However, Wang said he had heard earlier in the day from U.S. officials that due to internal G-7 divisions, the October 18 leaders' meeting is cancelled. He noted how the U.S.-China relationship had changed: in the past, the United States would decide whether to have a multilateral meeting and then informed China, while now it reached out to China in advance of a decision.

Hopes for New Administration

¶18. (SBU) Wang noted that while past Administrations have taken 1-2 years to clarify their China policies, he expected the next Administration would move much more quickly. He stressed that China needs a constructive and cooperative relationship with the United States for China to have a "peaceful" external environment so its can achieve its development goals. Globalization is an unstoppable force, he stated, and the U.S. and China's interests are inextricably intertwined.

¶19. (SBU) Senator Hagel agreed that the next President will not have the luxury of time to put his policies in place and would have to act quickly to map out their strategy for solving the financial crisis. He said that both Senators Obama and McCain understand the fundamental relationship between the United States and China, stressing that the two countries are intertwined and a "divorce" is not possible.

Larger Relationship, SED, and Taiwan

¶10. (SBU) Wang noted appreciation for the collaborative approach to bilateral relations established under the Strategic Economic Dialogue (SED) and highlighted that the SED had laid the groundwork for senior officials to be able to communicate daily. Through the SED and the Joint

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Commission of Commerce and Trade (JCCT), issues important to either side are on the table for discussion, including IPR, investment, energy and the environment, high-technology trade, food and product safety, and agricultural trade.

¶11. (SBU) On the broader U.S.-China relationship, Wang said there was no difference on fundamental interests. In his view the main disagreements were over the "internal sovereign issues" of Tibet, Taiwan, and Xinjiang. Wang appreciated U.S. support for the Beijing Olympics, and said the President's visit at a time of financial stress in the United States was warmly received. However, he expressed concern about the recent arms sale to Taiwan. In Wang's view, the weapons were less of a concern than the signal the sale provides that will embolden supporters of Taiwan independence. He noted the timing was regrettable as U.S.-China relations had improved after Chen Shui-bian's election loss. Nevertheless, Wang said China would continue to cooperate with the United States on coordinated responses to the financial crisis. Senator Hagel agreed that, while the U.S. and China will continue to have differences, these differences should not be allowed to frame the relationship.

Central Bank: Chinese Response to Situation

¶12. (SBU) At his meeting with Senator Hagel, PBOC Governor Zhou Xiaochuan noted that China is following the U.S. financial turmoil closely, both because Chinese economic and financial markets are now integrated into global markets, and because China is a major investor in U.S. Treasuries and government agency securities. Noting that he did not speak for the Congress or any Administration, Senator Hagel sought to reassure Governor Zhou that Fannie Mae and Freddie Mac might emerge in a few years with different structures, but the U.S. government would stand behind the organizations. Zhou hailed the major central banks' coordinated action to "rescue" the financial system.

¶13. (SBU) Governor Zhou noted that he would see Secretary of Treasury Paulson and Federal Reserve Chairman Bernanke this weekend. (Note: This was an apparent reference to the

suggested summit referenced by Wang Qishan. End note.)

¶14. (SBU) Zhou said the Chinese Government and the PBOC are prepared to do whatever is necessary to assist in stabilizing markets, including injecting liquidity into the Chinese market. The Chinese financial markets, however, are still "not sophisticated" and capital income is low, so China is not as affected by the unrest in the global financial markets.

¶15. (SBU) Moving forward, Zhou said that the Government's economic goals had shifted suddenly from "controlling inflation" to providing a "flexible and prudent" response to the global situation. Following the Third Party Plenum this weekend (see reftel), the PBOC was now hard at work developing a "probably temporary" response package. (Note: At the Politburo-level meeting that ended on Monday, leaders had been expected to discuss appropriate fiscal and monetary measures to respond to tighter global credit conditions and falling demand in China's major export markets. End note.)

Macro and Rural Reform

¶16. (SBU) Turning to rural reform, the official focus of the Plenum, Zhou noted that, because China needs to control migrant labor, the land reform process must be orderly. He

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thought that the size of farms would remain small, but farmers would be allowed to diversify their activities to maximize production. (Embassy comment: Observers had expected that the Plenum to move forward on land reform, allowing farmers to transfer and consolidate land to improve productivity and yields. Some social critics had worried that this would create a class of landless peasants if the economy slowed. Zhou's comments may indicate that concerns over migrant labor may have tempered enthusiasm for sweeping land reform at the Plenum. End comment.)

¶17. (SBU) He said the government for the past five years has encouraged farmers entering the work force to move into non-export dependent industries. This was part of an effort to transition China from an export-led to a domestic consumption-led economy. The Chinese people, however, due their long experience with shortages, tended to have high consumption rates. That said, retail sales growth was strong, and service sector demand was gradually increasing.

Commerce Ministry: Collaboration, not Protectionism

¶18. (SBU) Commerce Vice Minister Ma said China fully understands the gravity of the financial crisis. She said China first will continue to work with other major economies to cooperate in solving the financial crisis. Second, China would continue to reform and open its economy, and oppose protectionist measures and sentiments. According to Ma, China has had great success in increasing U.S. exports to China, and increased Chinese demand will create opportunities for U.S. exporters. Increased Chinese demand for nuclear and clean energy technologies also creates opportunities for U.S. technology exports. Third, as world demand slows, China will stabilize its own growth through stimulating domestic consumption, including through the implementation of measures delineated at the Third Plenum of the 17th Party Congress. Maintaining China's internal economic stability in itself contributes to global stability.

¶19. (SBU) Both sides discussed the importance of international cooperation in addressing the financial crisis, and emphasized the common interest in opposing increased protectionist sentiment. Vice Minister Ma noted that changes in U.S. presidential administrations present

challenges in our bilateral relations.

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